



DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

OFFICE OF
CHIEF COUNSEL

CC:DOM:FS:CORP
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October 26, 1999

INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR ASSOCIATE DISTRICT COUNSEL,

Attn:

FROM: DEBORAH A. BUTLER
ASSISTANT CHIEF COUNSEL CC:DOM:FS

SUBJECT: Properly Computing Loss Disallowance Rules Under Treas.
Reg. section 1.1502-20

This Field Service Advice responds to your memorandum dated September 13, 1999. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be cited as precedent.

LEGEND

Ultimate Parent =
Group

Ultimate Parent =

Ultimate Sub =

Target Parent Group =

Target Parent =

Target Sub 1 =

Target Sub 2 =

Line of Business B =

Line of Business C =

State X =

Asset C =

Asset D =

Individual B =

Month B =

Month C =

Date B =

Date C =

Date D =

Year B =

Year C =

Year D =

Year E =

\$B =

\$C =

\$D =

\$E =

\$F =

\$G =

\$H =

\$J =

\$K =

\$L =

\$M	=
\$N	=
\$O	=
\$P	=
\$Q	=
\$R	=

ISSUES

What facts should be developed by the revenue agent in order to determine whether the disallowed loss reported by Ultimate Parent on the sale of its stock in Target Parent, a wholly owned affiliated subsidiary, under Treas. Reg. section 1.1502-20 (-20) was properly computed.

CONCLUSIONS

Per your request, we have developed a set of facts that need to be developed in audit in order to determine whether Ultimate Parent properly applied the loss disallowance rules ("LDR") of -20. Additionally, we have listed facts that need to be developed to support the Service's argument that -20 is valid. We recommend that you develop the facts of your case in accordance with the advice set forth below. To the extent the factual development of your case leads to a conclusion that the LDR apply, the national office is interested in being involved in the development of the case.

FACTS

During the taxable year ended Date B, Ultimate Sub, a wholly-owned affiliate and member of the Ultimate Parent Group, acquired the stock of the Target Parent Group for about \$B. Target Parent Group consisted of Target Parent, Target Sub 1, a first tier subsidiary, and Target Sub 2, a second tier subsidiary. The Target Parent Group was principally involved in the Line of Business B. Goodwill, which included the value of the trademarks,¹ was valued in the financial statements at \$C but the goodwill and the trademarks had a \$R tax basis.

¹We are unclear as to the portion of the \$C in goodwill that should be attributable to the trademarks alone.

During subsequent years, the Asset D of the Target Parent Group were sold off to third parties and Line of Business C was moved to other Ultimate Sub facilities. By the end of fiscal Year D, the only asset left at the Target Parent Group was a \$N note receivable from a third party and certain valuable trademarks both owned by Target Sub 1.² According to your incoming memorandum, Ultimate Sub then decided to cash out the note receivable,³ which was due on Date D, while retaining the trademarks which were valued in Month B of Year E at \$K-\$J.⁴

According to your incoming memorandum, Target Sub 1 contributed the trademarks to Target Sub 2 in a section 351 transaction and then had the Target Sub 2 stock distributed upstream as a section 301 dividend from Target Sub 1 to Target Parent and then to Ultimate Sub. Target Sub 1 was then merged into Target Parent. On Date C, the stock of Target Parent was sold by Ultimate Sub to Individual B, an unrelated third party, for \$L. Ultimate Parent claimed a loss on this stock sale of \$H on its return for the year ended Date C.

²The note would have generated \$Q more if Ultimate Sub had held it to maturity. The note was obtained in Month C Year C from a State X general partnership, which was unrelated to Ultimate Parent or any of the Target Parent Group, in connection with the exchange for Asset C which Target Sub 1 owned in State X.

³According to your subsequent correspondence, you indicate that Target Sub 1 always held the note. However, the incoming memorandum indicates Ultimate Sub held the note. We do not understand the facts. If Target Sub 1 always held the note, we don't understand how this can be reconciled with your statement that Ultimate Sub cashed out the note. If Ultimate Sub received the \$N note, we do not understand how Ultimate Sub received the \$N note from Target Sub 1 and how it was treated for tax purposes.

⁴As previously indicated, we do not know the fair market value or cost of the trademarks when purchased in Year B.

This loss was computed as follows:

Amount realized	\$M
Basis of stock	<u>(\$E)</u>
	(\$F)
Less loss disallowed under Treas. Reg. section 1.1502-20(c)	<u>\$P</u>
Loss Claimed	<u>(\$H)⁵</u>

Ultimate Parent later amended its loss computation thereby increasing the allowable loss to \$G. This computation results from a higher basis of \$D for the stock and a higher disallowed loss under section 1.1502-20(c) of \$O.

Ultimate Sub has submitted computations to show how it calculated both its basis in the Target Parent stock and the loss disallowed under Treas. Reg. section 1.1502-20(c). The revenue agent questions whether this loss disallowance calculation is correct and seeks guidance as to what facts should be developed in order to determine whether this loss was properly computed under Treas. Reg. section 1.1502-20.

Also, according to your incoming memorandum, the trademarks were owned by Target Sub 2 when Ultimate Sub received the Target Sub 2 stock. Target Parent was then sold off to Individual B. According to the attachment to your incoming memorandum, you indicate that the trademarks, which had a fair market value of \$J but a \$R tax basis, were not included as either extraordinary gain dispositions or positive investment adjustments in determining the disallowed loss computation under Treas. Reg. section 1.1502-20(c). Your incoming memorandum questions the validity and correctness of Ultimate Sub's loss computation with respect to these transactions.

⁵We assume minor differences are due to rounding.

LAW AND ANALYSIS

The Loss Disallowance Rules

A. Historical Overview

The Tax Reform Act of 1986, Pub. L. 99-514, 1986-3 C.B. (Vol. 1) 1 ("1986 Act") repealed the General Utilities doctrine. The General Utilities doctrine, which takes its name from General Utilities & Operating Co. v. Helvering, 296 U.S. 200 (1935), was codified in I.R.C. sections 311, 336, and 337 of the Internal Revenue Code of 1954.⁶ The doctrine provided an exception to the two-level system of corporate taxation by according nonrecognition treatment to gain or loss resulting from a corporation's disposition of appreciated or depreciated property to its shareholders, either in liquidation (former I.R.C. section 336), or as a dividend (former I.R.C. section 311), or when it sold the property and distributed the proceeds in liquidation (I.R.C. section 337). The 1986 Act repealed the General Utilities doctrine by amending I.R.C. sections 311, 336, and 337 to require, with limited exceptions, the corporate level recognition of gain on a corporation's sale or distribution of appreciated property, irrespective of whether it occurs in a liquidating distribution or a sale in connection with a liquidation.

The statutory amendments under the 1986 Act implemented General Utilities repeal in the separate return context. Congress enacted I.R.C. section 337(d), which specifically authorizes the Secretary to prescribe such regulations as may be necessary or appropriate to carry out the purposes of the amendments made by the 1986 Act, including regulations to ensure that such purposes may not be circumvented through the use of any provision of law or regulations (including the consolidated return regulations). The LDR carry out the purposes of these amendments in the consolidated return context.

In the consolidated return context prior to these amendments, when a target company sold or distributed appreciated property to members of an acquiring group, that group could obtain a loss on the subsequent sale of the target company due to a positive basis adjustment which was made when the target company sold or distributed the appreciated property. This result was contrary to the repeal of the General Utilities doctrine. Instead, the shareholders should have reported a gain on the sale of the target company, and the target company should have paid a tax on its built-in gains. The -20 regulations were promulgated to provide a result in the

⁶All section references will refer to the Internal Revenue Code of 1986, unless otherwise specified. For example, Code sections under the Internal Revenue Code of 1954 will be referred to as a "former" section.

consolidated return context that was consistent with the repeal of the General Utilities doctrine.

B. Application of LDR

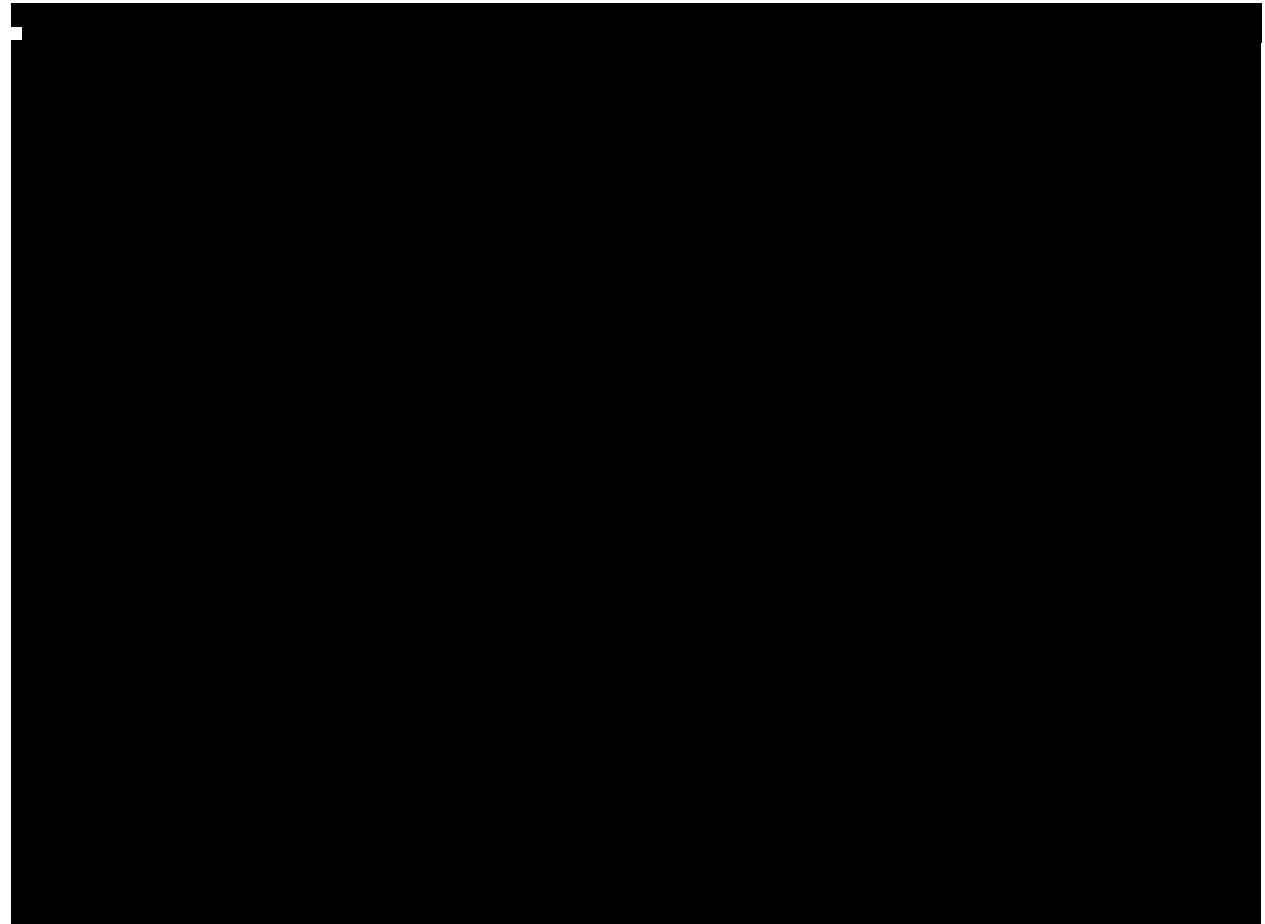
The LDR generally provide that no deduction is allowed for any loss recognized by a member with respect to the disposition of stock of a subsidiary. "Disposition" means any event in which gain or loss is recognized, in whole or in part. Treas. Reg. section 1.1502-20(a)(2). Treas. Reg. section 1.1502-20(c) specifies that the amount of loss disallowed under paragraph (a)(1) with respect to the disposition of a share of stock will not exceed the sum of the following three items: (1) extraordinary gain dispositions; (2) positive investment adjustments; and (3) duplicated loss.

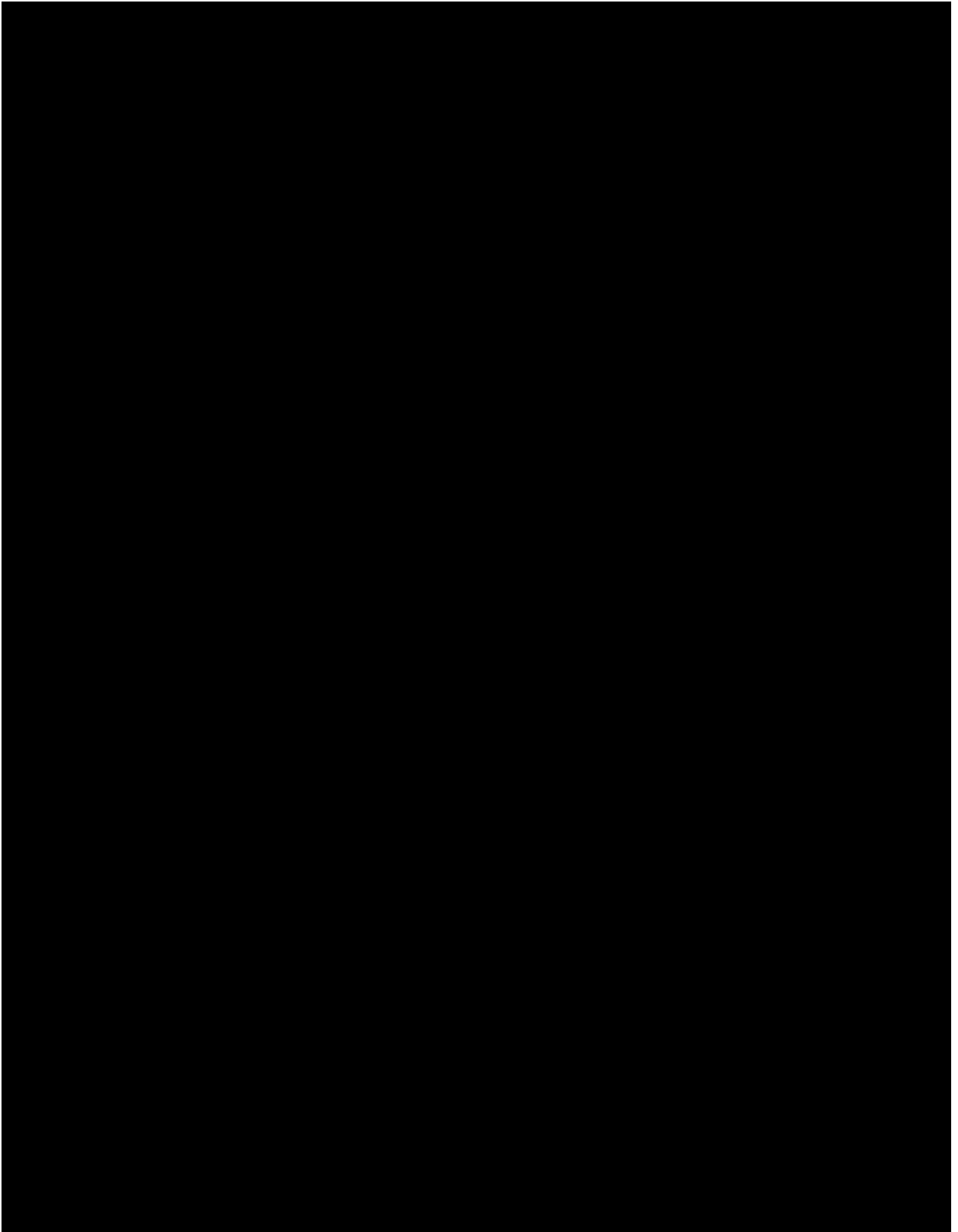
Extraordinary gains: Loss on the sale of a share of stock is disallowed to the extent of the share's allocable portion of any member's earnings and profits, net of directly related expenses (e.g. commissions, legal fees, state income taxes), attributed to actual or deemed gain dispositions occurring after November 18, 1990, of (1) capital assets; (2) section 1231(b) property (e.g., depreciable property or land used in a trade or business); (3) bulk sales or other dispositions of nondepreciable business assets, such as inventory, copyrights, or receivables used in the same trade or business; (4) dispositions of business assets described in section 1060(c); (5) any positive section 481 adjustments resulting from a change of accounting method, including a change attributable to pre-November 19, 1990 periods (e.g., recovery of LIFO reserve); (6) income from discharge of indebtedness (not excluded from basis under section 1503(e); and (7) any other event (or item) identified in revenue rulings and revenue procedures. Treas. Reg. section 1.1502-20(c)(2)(i). These extraordinary gain dispositions apply only to the extent that immediately before the disposition of the share, they are directly or indirectly reflected in the basis of the share after applying the basis adjustment rules of section 1503(e), Treas. Reg. section 1.1502-32(g), and other applicable provisions. Treas. Reg. section 1.1502-20(c)(2)(iii).

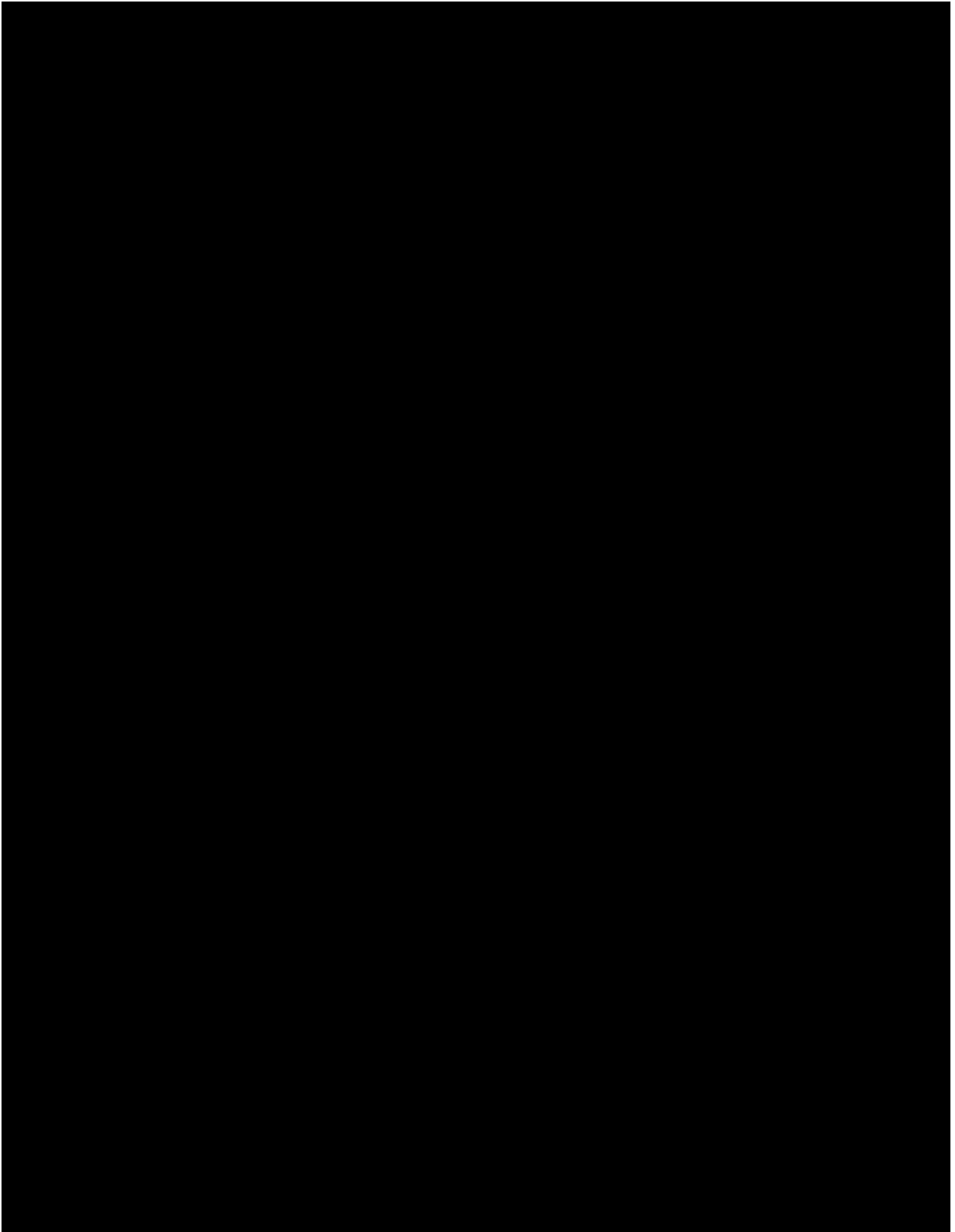
Positive investment adjustments: In calculating the disallowed loss, the regulations consider positive investment adjustments. These are the annual earnings and profits (before distributions) (other than those covered by the extraordinary gain provisions), that result in positive basis adjustments under Treas. Reg. section 1.1502-32(b)(1)(i) and (c)(1). These earnings and profits adjustments apply only to the extent that immediately before the disposition of the share, they are directly or indirectly reflected in the basis of the share after applying the basis adjustment rules of I.R.C. section 1503(e), Treas. Reg. section 1.1502-32(g), and other applicable provisions. To a limited extent, deficits of one year can be offset against earnings and profits of another year for tax years ending on or before September 13, 1991. However, they cannot be netted for years thereafter.

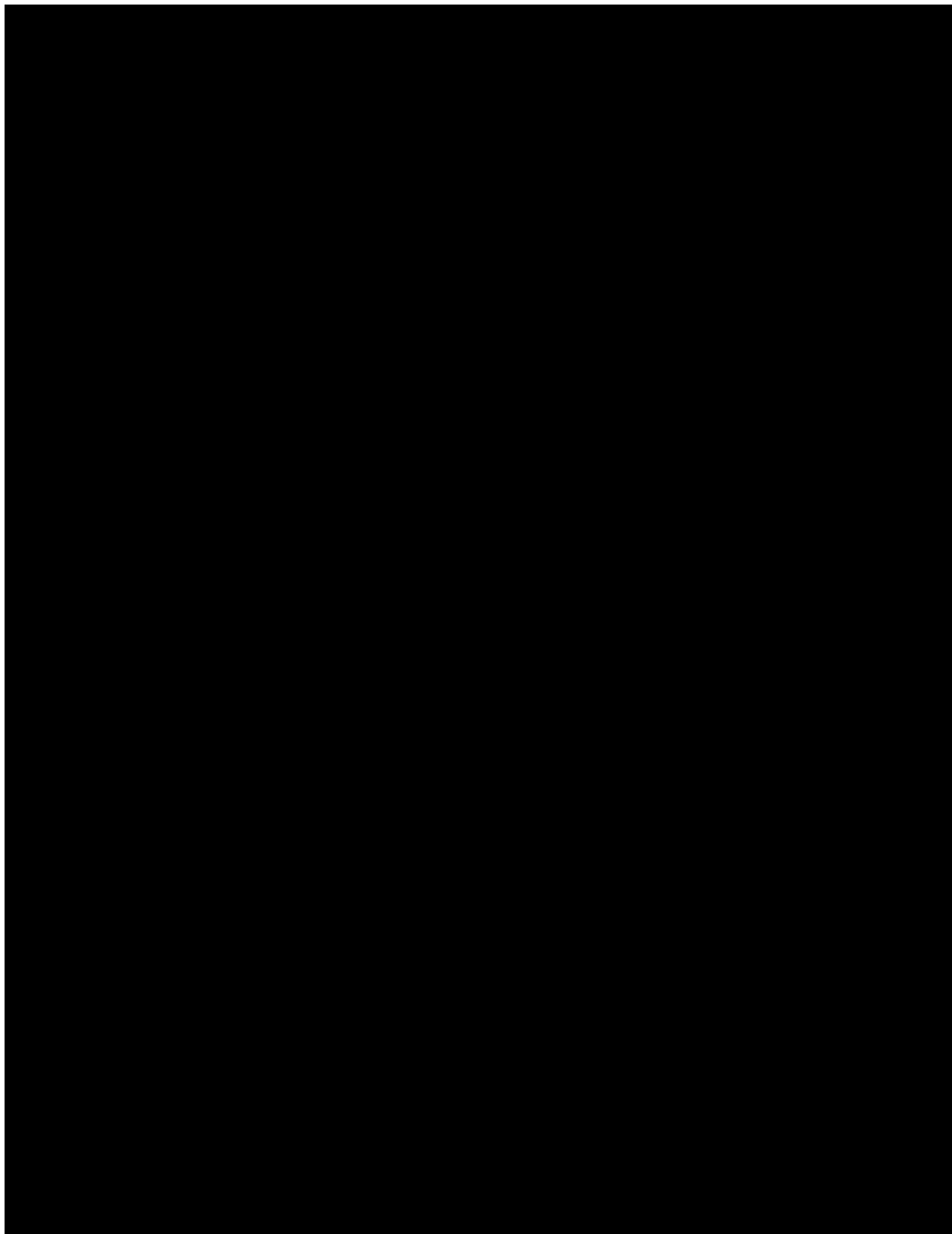
Duplicated loss: The amount of duplicated loss apportioned to each share is the portion of the loss carryforwards and net built-in losses attributed to the share. Treas. Reg. section 1.1502-20(c)(2)(vi). The amounts determined under this paragraph with respect to a subsidiary must include the subsidiary's allocable portion of corresponding amounts with respect to each of its lower-tiered subsidiaries. The duplicated loss amount is determined immediately after a disposition by first adding (1) the aggregate adjusted basis of the subsidiary's assets, but not the adjusted basis of its stock or securities in a group member; (2) any losses attributable to the subsidiary and carried to its first taxable year after the disposition; and (3) any deferred deductions (such as passive losses under I.R.C. section 469) of the subsidiary. The total amount is then reduced by the sum of (1) value of the subsidiary's stock; (2) liabilities of the subsidiary; and (3) any other relevant items.

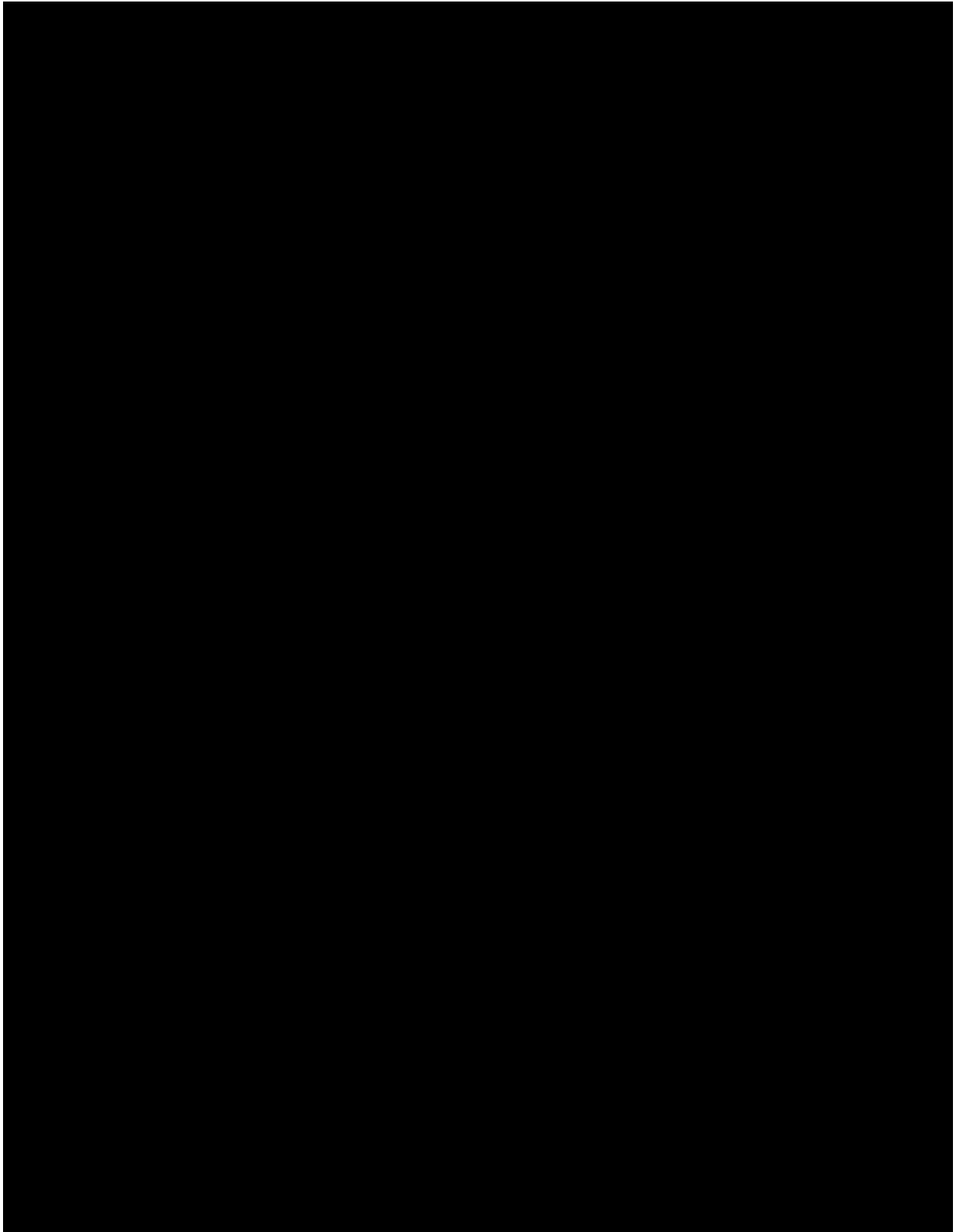
CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS











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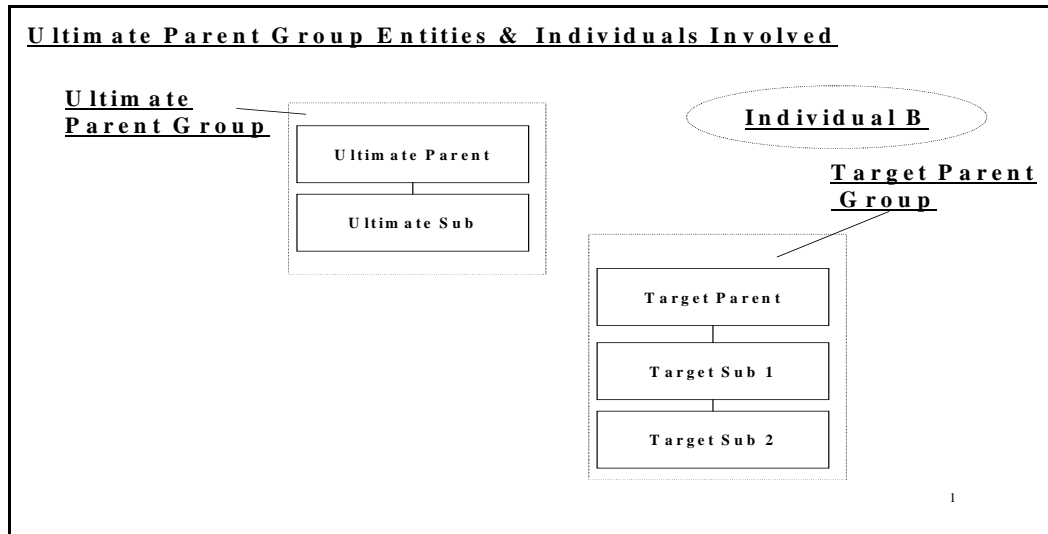
Please call us at
(202) 622-7930 if you have any further questions.

Deborah A. Butler
Assistant Chief Counsel

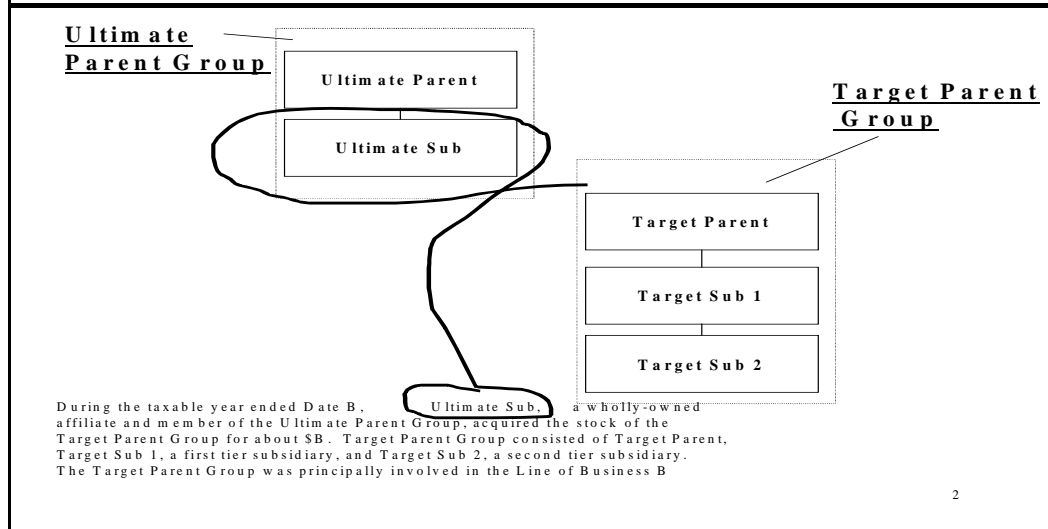
By: _____
ARTURO ESTRADA
Acting Branch Chief
(CC:DOM:FS:CORP)

Attachment (1) Ten page Powerpoint Diagram Regarding Facts

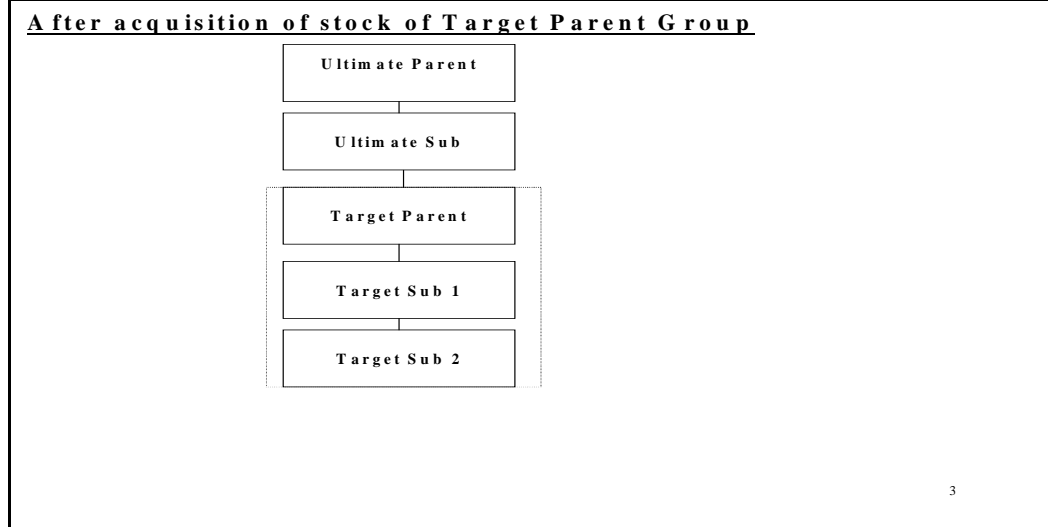
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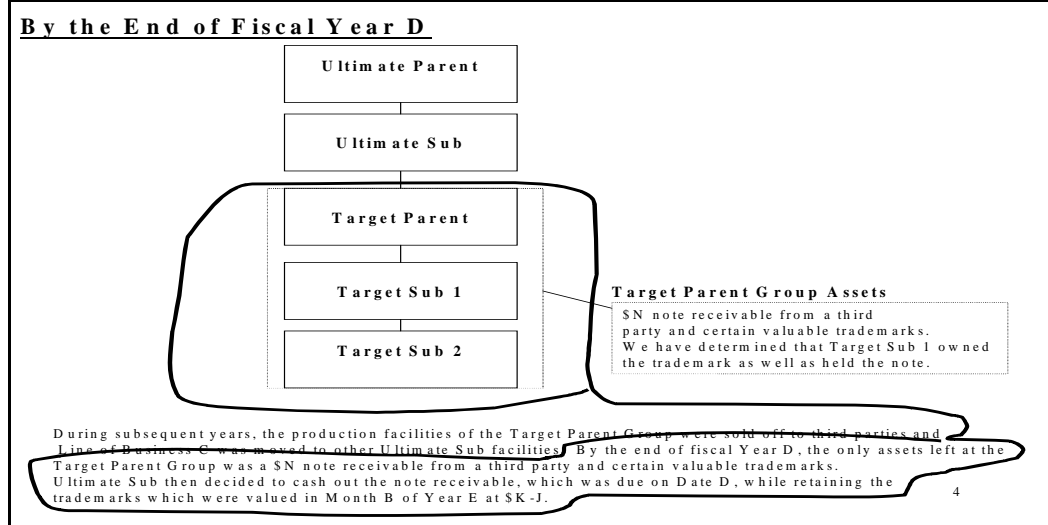
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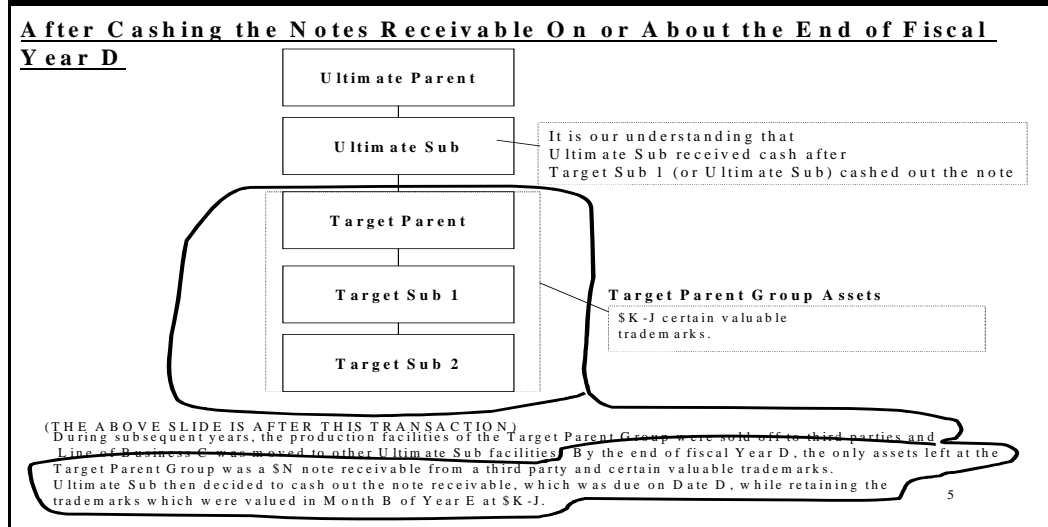
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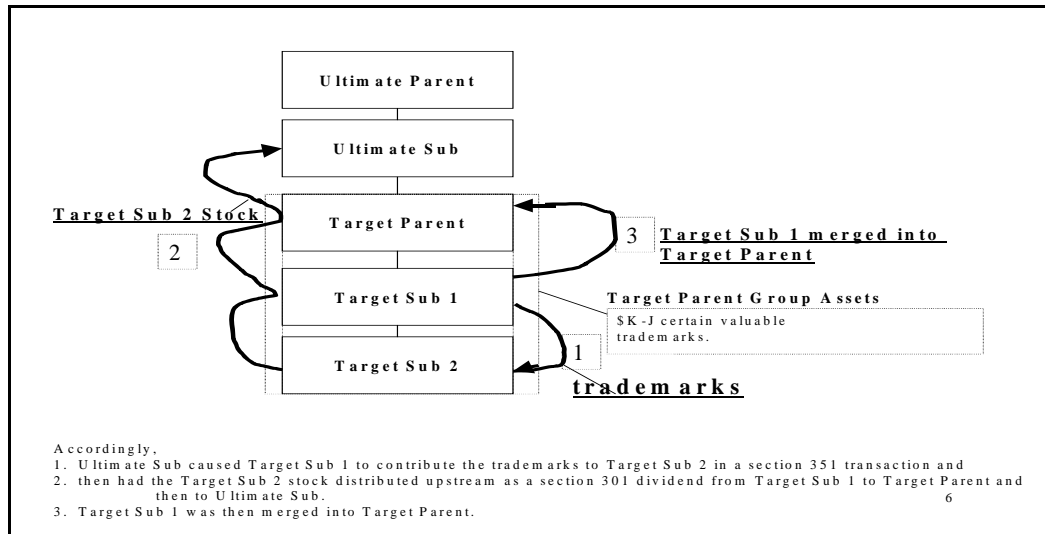
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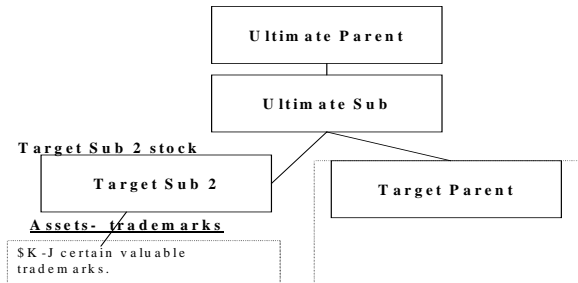


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Slide 7

After Contribution of Trademarks to Target Sub 2, Target Sub 2 stock to Ultimate Sub and Target Sub 1 merger into Target Parent



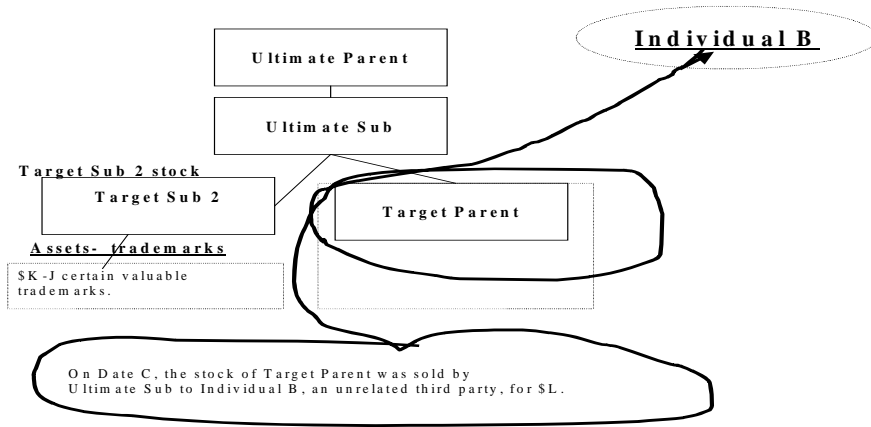
(THE ABOVE SLIDE IS AFTER THIS TRANSACTION)

1. Ultimate Sub caused Target Sub 1 to contribute the trademarks to Target Sub 2 in a section 351 transaction and
2. then had the Target Sub 2 stock distributed upstream as a section 301 dividend from Target Sub 1 to Target Parent and then to Ultimate Sub.
3. Target Sub 1 was then merged into Target Parent.

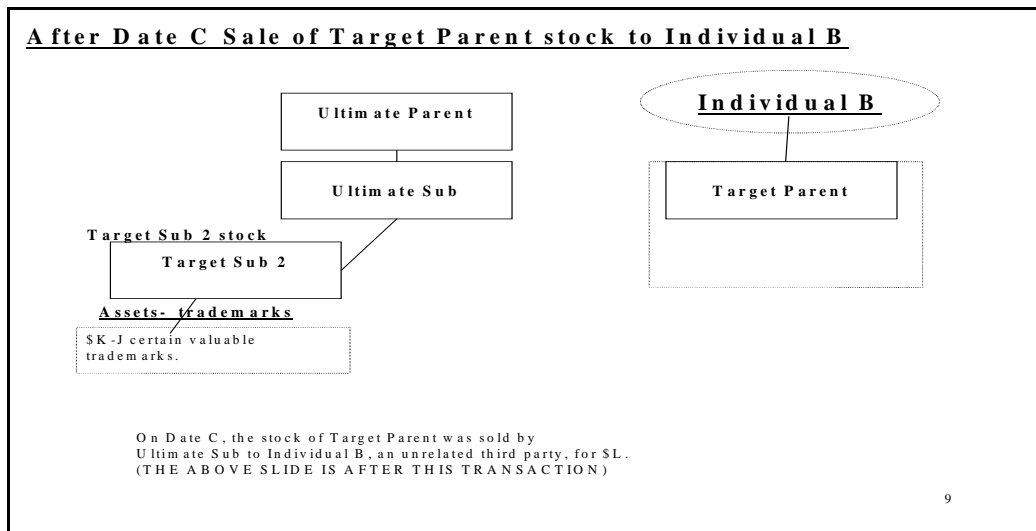
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Slide 8

Date C Target Parent stock sold



Slide 9



Slide 10

